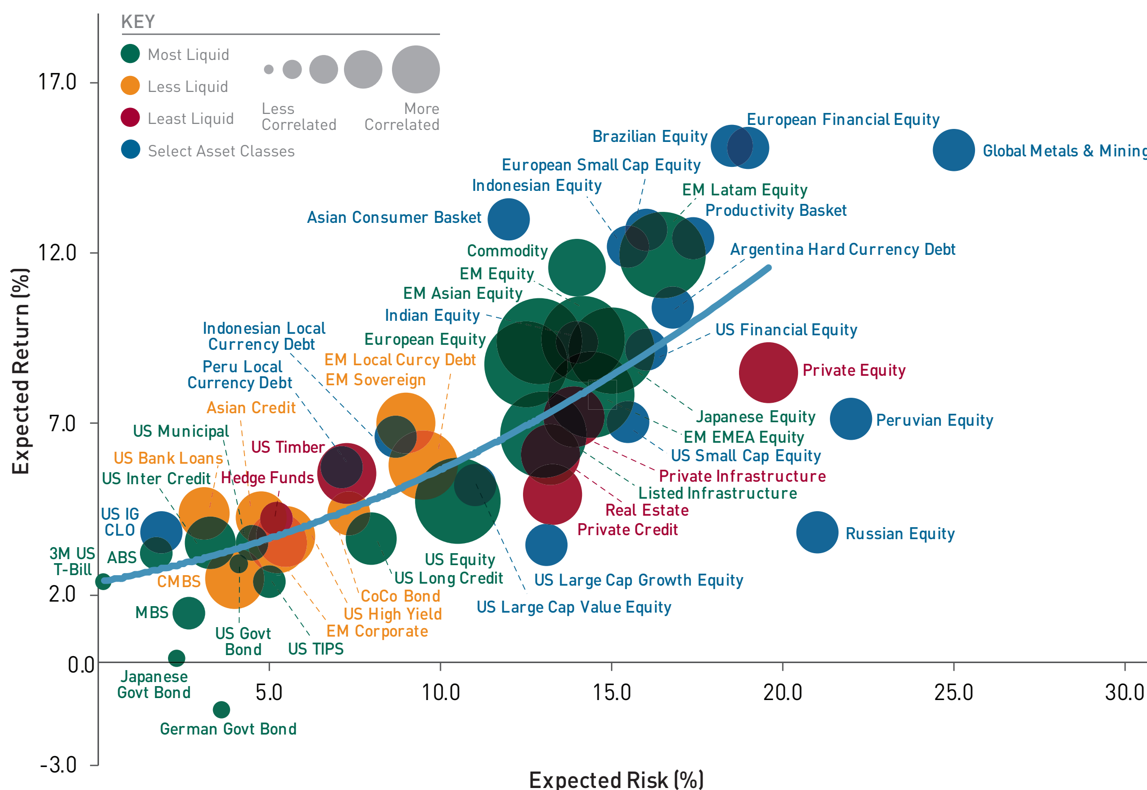
» CAPITAL MARKET LINE 30 JUN 2018

DISTINGUISHING RISK FROM UNCERTAINTY

Global uncertainty has risen. Growth outside of the US has slowed, at least temporarily, and the world all of a sudden appears less synchronized. The European Central Bank has joined the Federal Reserve in winding down extraordinary monetary policy, and the post-World War II global trading order may be ending. Amid rising economic and political uncertainty, it's natural to think in terms of dimming prospects for risk-taking. Yet not all uncertainty materializes into actual risk. Some represents opportunity, which we believe is currently beckoning in many areas.

We see the likelihood of faster growth, even if it's with a wider range of outcomes. Muted homogenous cash flow growth, powered by ever-expanding liquidity, drove the low-risk post-crisis bull market. That ended in the middle of 2016, in tandem with post-crisis drags. We now have faster yet more divergent cash flow growth, with more and more pockets outpacing the world's slowly diminishing liquidity. A medium-risk bull market has unfolded, which should continue as long as geopolitical uncertainty does not manifest itself in actual risk.

CAPITAL MARKET LINE AS OF 30 JUNE 2018 (USD VIEW, LOCAL CURRENCY)



Based on PineBridge Investments' estimates of forward-looking five-year returns and standard deviation. The Capital Market Line ("CML") is not intended to represent the return prospects of any PineBridge products, only the attractiveness of asset class indices, compared across the capital markets. Please see Capital Market Line Endnotes. Note that the CML's shape and positioning were determined based on the larger categories and do not reflect the subset categories of select asset classes, which are shown relative to other asset classes only.

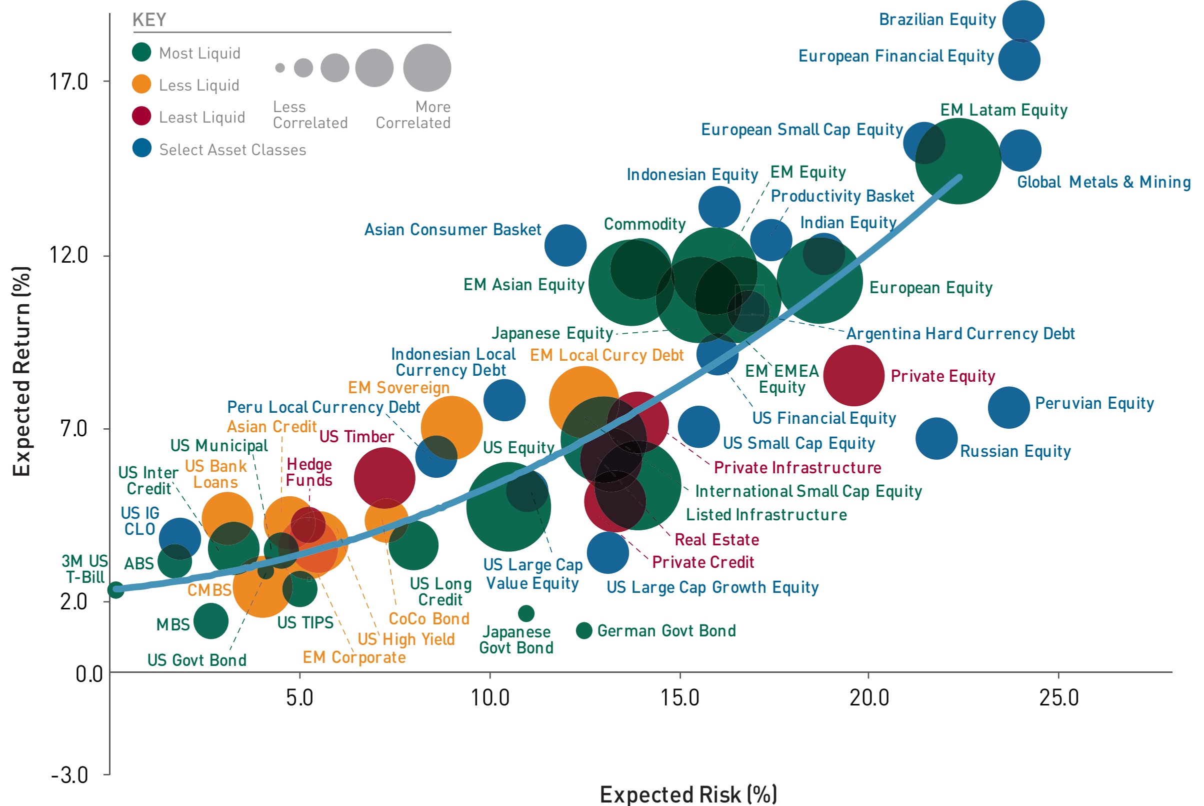
THE PINEBRIDGE GLOBAL MULTI-ASSET SERIES:

CAPITAL MARKET LINE
Quarterly five-year forecast of relative risk and return across asset classes.

MULTI-ASSET STRATEGY
Monthly asset class convictions and risk positioning.

INVESTMENT STRATEGY INSIGHTS
Monthly views from our diverse global investment teams.

CAPITAL MARKET LINE AS OF 30 JUNE 2018 (USD VIEW, UNHEDGED)



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For us, that would mean political decisions on trade and oil supply that neither spike inflation nor put a serious dent in global growth. We don't think they will.

Meanwhile, growth and inflation wobbles reflect inventory positions and production bottlenecks that, to our eye, are characteristics of growth spurts, not demand weakness. The pace of today's earnings growth, accompanied by mild inflation, points to midcycle dynamics.

Led by a burgeoning investment cycle, we expect a re-acceleration of growth, with the next leg up characterized by productivity. Should a fourth industrial revolution materialize from this AI-powered investment cycle, as many now believe, it's instructive to remember that the first, second, and third industrial revolutions were all driven by new enabling technologies that elevated productivity, elongated the cycle, and resulted in rapid disruptive growth without inflation. What is different this time around is a lingering global savings glut, which will ensure that cash flow growth will remain well capitalized, even if a bit less so. We also expect the Fed to pause upon reaching the new lower neutral level of fed funds as it becomes evident that inflation won't hold above its target, and that artificial intelligence is cooling off the employment situation. In Europe, Mario Draghi once again managed to extend the life of negative interest rates. A reacceleration of cash flows appears to be the path forward without a meaningful tightening of the noose.

And while trade negotiations have generated short-term uncertainty, we continue to see the likelihood that more discussion will lead to overall trade barriers coming down, fostering more trade, not less – even if the road is bumpy, disruptive, and uncertain.

INSIGHTS FROM TODAY'S CML

Lower prices and robust fundamentals make growth assets more attractive. While strong earnings growth carried through into 2018 at a global level, markets have sold off since February. Together, this has compressed valuation multiples. Since we see the recent slowdown as transitory and largely a natural consolidation of the exceptional growth of 2017, we have maintained our constructive expectations over the intermediate term, which implies that forward-looking expected returns have become a bit more attractive. This is particularly the case in several emerging markets nations and in Europe, where output gaps remain negative, enabling earnings to achieve a higher beta to nominal GDP growth.

Developed market bonds remain unattractive, particularly in the eurozone. Over the past two years, US rates have shifted higher and closer to the "neutral rate" level. We believe that peak interest rates will be substantially lower than in previous cycles, limiting the downside for US Treasuries even if upside potential also remains unattractive. Not so for German Bunds. A final dovish push by Draghi before his exit from the ECB has pushed rate hikes into late 2019 and led to a reversal in Bund yields. Yet growth is beginning to stabilize and will be sustainably higher over the coming years due to Europe's pent up investment and consumption demand. Long-cycle investment trends continue to strengthen, providing breadth to the domestic recovery that only started 18 months ago. Bunds have held down longer-dated US Treasuries, distorting the yield curve, as we have long maintained, and which a new Fed study demonstrates quite convincingly.

Resilient US high yield credit now appears less attractive. US high yield bonds have been remarkably resilient in the face of broad-based weakness across global markets. We have not needed to adjust our fundamental forecasts this quarter, and hence price action has made the asset class even less attractive in our framework. In contrast, US investment grade credit has experienced spread widening and suffered from its high level of interest-rate risk exposure. Our CML has flagged the unattractiveness of this asset class for several years, and its vulnerability to negative technical forces in an era of quantitative tightening remains palpable.

EM debt has become relatively more attractive, but only due to a few outliers. Emerging markets (EM) sovereign hard currency bonds have been negatively affected by US dollar strength and higher US yields. Yet under the hood, one observes that the market has bifurcated, with only a handful of idiosyncratic situations (Argentina and Turkey, for example) skewing the spread level of the benchmark. We are confident that fundamentals supporting EM sovereign credit are robust and vastly better than in past cycles, rendering current valuations rational and largely a reset from overvalued levels. Should there be further repricing, this may become an outright attractive allocation within EM.

India recovers from recent growth shocks and remains attractive. We have singled out India consistently over the past few years as having the key ingredients for an attractive equity market. While two self-inflicted shocks (demonetization and the introduction of the Goods & Services Tax) temporarily disrupted growth and made 2016-2017 difficult for equity investors, India has turned the corner. We see manifold confirmations of growth acceleration and forecast a bright future for India in the years ahead.

Commodity-related assets are attractively valued with supportive supply/demand dynamics. We have recently been highlighting the positive fundamentals of industrial metals and related equity sectors. Our view is primarily informed by highly supportive supply dynamics due to the capital discipline exhibited by global miners on the back of their woes during the unwinding of the commodity supercycle from 2012 to 2016. That experience continues to dissuade financing of raw capacity. Recent global growth consolidation and trade jitters also have pressured this sector's market value, although not its financials. We remain confident that demand is already recovering and able to easily support current valuations.

Private assets require selectivity and future-proofing. Investors continue to flock to private assets at a pace that exceeds asset managers' ability to absorb. At the same time, the corporate landscape is becoming increasingly disruptive across almost all sectors, creating a winner-takes-most environment with many losers. It is exceedingly difficult to identify the winners in such a milieu, and empirical evidence indicates that rapid technological development is typically coupled with a rise in bankruptcy and default rates, even into periods of faster growth. Hence the imperative, in our opinion, for "future-proofing" one's private investments, and our preference for segments of private markets with shorter J-curves as well as smaller funds, which can afford to be more selective.

THE FUNDAMENTALS DRIVING OUR CML

Corporate investment activity continues to gather pace. Checks of our internal and external channels confirm the nascent upward trend in corporate investment activity that we have highlighted in recent months. Industry leaders are leading the charge, particularly in developed markets, and equity investors are clearly rewarding well-designed growth plans. Highest on the list of priorities remains IT investment spending, which powers tremendous efficiency improvements that could well lead to further margin gains even in the face of rising input costs. This type of investment activity has been virtually nonexistent for a decade; investors should avoid extrapolating growth/inflation dynamics from the previous market regime and factor in the disinflationary effects of these new technologies.

Inflation has normalized but remains benign. After a global inflation dip that was caused by transient factors (a collapse in oil prices and China's "hard landing" in 2015-2016), inflation has normalized. Meanwhile, China's supply-side reforms are progressing and removing the unhealthy deflationary impulse that has plagued the global economy for over a decade. As a result, firms are confirming better pricing power (i.e., reflation), which is encouraging a healthy cycle of productive investment that dampens overall pricing pressure (i.e., inflation). Overheating remains the key risk to watch for in coming years, but it will be slow to materialize due to the offsetting drivers of latent slack and productive corporate investment.

US interest rates are approaching the "neutral" level. The real "neutral" rate of interest – a level that sustains non-inflationary growth – is unobservable, yet it has become a key measure for policymakers. For the US, we believe the rate is now around 0.5%. A critical question will be how the Fed proceeds after one or two more rate hikes, as it may wish to avoid inverting the yield curve after reaching neutral, especially if supply-driven growth dampens inflation expectations and AI begins to cool wage pressure. At most, we expect the Fed to hike just once or twice past neutral, or it may just pause. As a result, peak interest rates in this cycle will be significantly below those seen in previous cycles, and this has profound implications for financial asset return outcomes, as reflected in our Capital Market Line.

China's supply-side reforms are making substantial progress. Our network of colleagues and institutional partners across China confirms the commitment and follow-through of the Chinese authorities in implementing supply-side reforms across the "old economy" and in the financial sector. Strict environmental standards now being enforced are being coupled with careful policies to transition workers into "new economy" sectors, enabling the economy to rebalance toward domestic consumption relatively smoothly. This has created a virtuous cycle that makes surviving firms more profitable and able to sustain wage increases that in turn support consumption. Independent of the negotiation process, we expect China to continue deleveraging its economy and thereby reducing the risk of disruption to global growth.

The EM growth setback is temporary. Much has been made of the recent slowdown in growth across emerging markets and the stronger US dollar pressuring EM economies. As a result, investors appear to be abandoning EM assets, driven by memories of previous periods of EM stress. We see things differently. While several factors have caused growth to weaken in EM after an exceptionally strong 2017, underlying growth drivers remain intact. First, the US dollar is structurally challenged by substantial twin deficits, and peak US rates are not far off. Second, the lack of currency pegs and issuance of local currency debt has left EM external accounts much healthier and more sustainable than in the past. But selectivity in EM remains absolutely critical as some economies, notably Argentina and Turkey, are exceptions to the rule and have been identified by markets as requiring a price reset.

Trade negotiations will be intense but ultimately positive. We have been expecting negotiations between the US and its trading partners to be intense and different in nature from those of prior US administrations. Yet we did not expect the US to proceed with unilateral tariffs of any substantial magnitude. We still do not expect this worst-case outcome, although risks of a prolonged stalemate have risen. In the near term, we recommend that investors watch corporate investment activity as the key variable to determine the impact of tariffs on the outlook for fundamentals, as it has the potential to erode willingness to invest. Over the intermediate term, however, we expect a resolution in the form of more open economies and lower tariffs. Notwithstanding this positive outcome, the road to that destination is likely to be very bumpy.

ABOUT THE CAPITAL MARKET LINE

The Capital Market Line (CML) is a tool developed and maintained by the Global Multi-Asset Team. It has served as the team's key decision support tool in the management of our multi-asset products. In recent years, it has also been introduced to provide a common language for discussion across asset classes as part of our Investment Strategy Insights meeting. It is not intended to represent the return prospects of any PineBridge products, only the attractiveness of asset class indexes compared across the capital markets.

The CML quantifies several key fundamental judgments made by the Global Multi-Asset Team after dialogue with the specialists across the asset classes. We believe that top-down judgments regarding the fundamentals will be the largest determinants of returns over time driving the CML construction. While top-down judgments are the responsibility of the Multi-Asset Team, these judgments are influenced by the interactions and debates with our bottom-up asset class specialists, thus benefiting from PineBridge's multi-asset class, multi-geographic platform. The models themselves are intentionally simple to focus attention and facilitate a transparent and inclusive debate on the key drivers for each asset class. These discussions result in 19 interviews focused on determining five year forecasts for over 100 fundamental metrics. When modelled and combined with current pricing, this results in our annualized expected return forecast for each asset class over the next five years. The expected return for each asset class, together with our view of forward-looking risk for each asset class as defined by volatility, forms our CML.

The slope of the CML indicates the risk/return profile of the capital markets based on how the five-year view is currently priced. In most instances, the CML slopes upward and to the right, indicating a positive expected relationship between return and risk. However, our CML has, at times, become inverted (as it did in 2007), sloping downward from the upper left to the lower right, indicating risk-seeking capital markets that were not adequately compensating investors for risk. We believe that the asset classes that lie near the line are close to fair value. Asset classes well above the line are deemed attractive (over an intermediate-term perspective) and those well below the line are deemed unattractive.

We have been utilizing this approach for over a decade and have learned that, if our judgments are reasonably accurate, asset classes will converge most of the way toward fair value in much sooner than five years. Usually, most of this convergence happens over one to three years. This matches up well with our preferred intermediate-term perspective in making multi-asset decisions.

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CAPITAL MARKET LINE ENDNOTES

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